or 4.3 percent. A LEC that selects and outperforms the 3.3 percent productivity offset is entitled to retain all of its earnings up to 1 percent above the initial 11.25 percent rate of return[315] (i.e., 12.25 percent).[316] A LEC using the 3.3 percent productivity offset must share 50 percent of its earnings between 12.25 percent and 16.25 percent, and 100 percent of its earnings in excess of 16.25 percent.[317] The sharing mechanism effectively allows a LEC selecting a 3.3 percent productivity offset to reach a maximum 14.25 percent rate of return.[318] A LEC selecting the higher 4.3 percent productivity offset may retain all of its earnings up to 13.25 percent. The LEC, however, must share with its customers 50 percent of its earnings between 13.25 percent and 17.25 percent, and 100 percent of its earnings in excess of 17.25 percent. The Commission stated that the sharing mechanism would "operate[] only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings . . . ."[319]

168. The other backstop mechanism, the low-end adjustment mechanism, was intended to prevent any price cap LEC from experiencing such low earnings over an extended period of time that its ability to provide quality service and attract capital would be seriously impaired.[320] Under the low-end adjustment mechanism, if the earnings of a LEC fall below 10.25 percent in a base year, the LEC may raise its PCI, and consequently its rates, in the following year to the level required to earn 10.25 percent, using the prior period as the baseline.[321] The low-end adjustment mechanism allows a LEC the opportunity to earn a 10.25 percent rate of return on a prospective basis, but does not guarantee that the LEC will achieve such earnings. We set the lower adjustment mark at a level which is symmetrical with the

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315 The initial 11.25 percent level corresponded to the rate of return established for rate-of-return carriers in Represcribing the Authorized Rate of Return for Interstate Service of Local Exchange Carriers, CC Docket No. 89-624, 5 FCC Rcd 7507 (1990) (Represcription Order).

316 LEC Price Cap Order, 5 FCC Rcd at 6788.

317 LEC Price Cap Order, 5 FCC Rcd at 6801.

318 LEC Price Cap Order, 5 FCC Rcd at 6801.

319 LEC Price Cap Order, 5 FCC Rcd at 6801; see also id. at 6788.

320 LEC Price Cap Order, 5 FCC Rcd at 6787, 6801-02; LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2677.

321 LEC Price Cap Order, 5 FCC Rcd at 6788.

12.25 percent top of the no sharing zone.[322] The low-end adjustment mechanism operates as a one-time adjustment to a single year's rates.[323]

169. In fashioning the backstop plan, we recognized on the one hand that it could reduce the LECs' efficiency incentives, and on the other that it might help achieve the goals of the Communications Act, including assurance of just and reasonable rates.[324] We concluded that the possibility of errors in the X-Factor supported adoption of the backstop, at least until we acquired additional experience with LEC price caps.[325]

170. In our Notice, we asked initially whether our concern that an erroneous X-Factor might produce unintended and undesirable results for individual LECs or their customers remained valid, or whether the backstop mechanisms could be replaced by adjustments to the X-Factor or other aspects of the plan. We also asked whether, in the event we decided to retain the backstop mechanisms, the mechanisms should be realigned with capital costs, and if so, how that realignment should take place.[326] We also asked whether the sharing and low-end adjustment mechanisms should be revised or eliminated.[327]

171. As discussed in the X-Factor section, supra, USTA presented a substantial revision to its LEC price cap plan proposal on January 18, 1995. In that revised proposal, USTA recommends replacing the backstop mechanisms with an X-Factor that would be adjusted automatically each year based on a five-year moving average of LEC total factor productivity (TFP) with a two-year lag. Our summary of the record concerning the backstop mechanisms describes first the initial round of comments and replies and then the comments filed in response to USTA's revised proposal.

2. Comments and Studies

a. Revising or Eliminating the Backstop Mechanisms

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[322] LEC Price Cap Order, 5 FCC Rcd at 6802.

[323] LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2691 n.166.

[324] LEC Price Cap Order, 5 FCC Rcd at 6801.

[325] Id.

[326] Notice, 9 FCC Rcd at 1697 (Baseline Issue 4a).

[327] Notice, 9 FCC Rcd at 1697 (Baseline Issue 4b).

172. Many commenters recommend elimination of both the sharing and low-end adjustment mechanisms.[328] SNET and Eagle recommend elimination of the sharing mechanism, but they express no opinion on the low-end adjustment issue.[329] Ameritech recommends eliminating the sharing mechanism and permanently embedding price cap LECs' 1994-95 sharing amounts in their baseline price cap indexes.[330] The commenters assert that the sharing and low-end adjustment mechanisms dull and distort LEC efficiency incentives.[331] Also, the commenters assert that the sharing mechanism discourages development of new services and investment in the domestic infrastructure.[332]

173. In addition, these commenters claim that there is no evidence of an error in the selection of the productivity offset or in any other aspect of the LEC price cap plan warranting retention of the sharing and low-end adjustment mechanisms.[333] GTE notes that the price cap plans for AT&T and the cable industry do not have sharing and low-end adjustment mechanisms,

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[328] USTA Comments at 9; Bell Atlantic Comments at iii; Lincoln Comments at 11; BellSouth Reply at 2; US West Comments at 8, 42; MFS Comments at 9; Pac Bell Comments at 43; NYNEX Comments at 28; SWB Comments at 43; CSE Comments at 5-6; GTE Comments at 67; RTC Comments at 12; Sprint Comments at 13-15; CSE Comments at 6.

[329] SNET Comments at 7; Eagle Comments at 1-2.

[330] Ameritech argues that the amount of sharing produced by price cap LECs by the third year of the plan provides a reasonable estimation of individual LECs' inherent productivity variations from the 2.8 percent productivity offset factor at the time price caps began. Ameritech Comments at 14-15.

[331] Eagle Comments at 2; USTA Comments at 9; US West Comments at 8, 42; Pac Bell Comments at 43; Lincoln Comments at 11; NYNEX Comments at 28; GTE Comments at 67; Ameritech Comments at 14, 16; BellSouth Comments at 50; AT&T Comments at 30, 35-37; Bell Atlantic Comments at 9; Ameritech Reply at 8.

[332] Pac Bell Comments at 43; NYNEX Comments at 29-30; SWB Comments at 44-45; Ameritech Reply at 3; BellSouth Comments at 56; USTA Comments at 22, 46; Lincoln Comments at 11-12. But see CSE Comments at 6 (sharing and low-end adjustments mechanisms lower the variance of expected returns from equity investments in LECs and, therefore, artificially encourage over-investments in LECs).

[333] Lincoln Comments at 12; CSE Comments at 5-6; GTE Comments at 67; BellSouth Comments at 50; Bell Atlantic Reply at 10-13; Eagle Comments at 2.

and contends that regulatory symmetry dictates that these mechanisms be eliminated from the LEC price cap plan.[334] CSE argues that these backstop mechanisms were intended to be interim safeguards and not long-term features of the LEC price cap plan.[335]

174. Some commenters claim that elimination of the sharing mechanism will provide the LECs with the opportunity to earn a return commensurate with investment risks,[336] and will enhance the LECs' ability to attract capital from international sources.[337] USTA and SWB argue that sharing creates an incentive to cross-subsidize competitive services or to price those services below incremental costs. They point out that, if sharing is retained, the Commission will need to develop a series of cost allocation procedures for price cap versus non-price cap services to prevent cross-subsidization.[338]

175. A number of carriers, including SWB, attach to their comments a study conducted by Strategic Policy Research (SPR).[339] According to SPR, a four-year hybrid price cap plan with a 50-50 sharing mechanism has less than 35 percent of the efficiency incentives provided in an unregulated competitive market, and that these incentives fall to only 18 percent of the efficiency incentives of unregulated competition for a LEC whose earnings are in the 50-50 sharing zone each year.[340] Ad Hoc criticizes the SPR study because it assumes that an unregulated, competitive firm would be able to keep 100 percent of its efficiency gains indefinitely.[341] Ad Hoc also claims that SPR does not adequately account for the efficiency incentives created by the 1 percent no-sharing zone.[342]

176. Other commenters recommend retention of the sharing

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[334] GTE Reply at 16.

[335] CSE Comments at 5-6.

[336] Bell Atlantic Comments at 9; Lincoln Comments at 11.

[337] USTA Comments at 47.

[338] USTA Comments at 48-50; SWB Comments at 44-45.

[339] "Regulatory Reform for the Information Age," Strategic Policy Research, Bethesda, MD (January 1994) (SPR study).

[340] SWB Comments, Appendix SPR at 22-23.

[341] Ad Hoc Reply at 15-18.

[342] Ad Hoc Reply at 18.

and low-end adjustment mechanisms, contending that these mechanisms protect ratepayers and stockholders from unusual circumstances that may impact individual price cap LECs, while the sharing mechanism ensures that ratepayers fully participate in efficiency gains.[343] CCTA asserts that, because network technology, demand and competition levels are in a state of flux, uncertainty regarding the appropriate productivity factor may have increased.[344] PaOCA and GSA recommend that the Commission retain the 50 percent sharing mechanism, but eliminate the 100 percent sharing requirement; they argue that the 100 percent sharing requirement provides the carriers with perverse incentives to cease controlling costs once they reach the 16.5 percent earnings level.[345] GSA asserts the sharing feature could not have limited the incentive for LECs to invest and become more productive, given that the RHCs earned over a billion dollars more than their cost of capital in 1993.[346]

177. AT&T, MCI, and ICA recommend elimination of the low-end adjustment mechanism and retention of the sharing mechanism.[347] MCI says the low-end adjustment mechanism should be eliminated because the price cap plan already contains protections to guard against confiscatory rates.[348] ICA recommends replacing the low-end adjustment mechanism with an "earning sharing indexing scheme" under which a LEC would offset an "earnings sharing obligation in one tariff year with its foregone profits from a prior year."[349]

178. Ad Hoc asserts that, given existing market conditions, effectively replicating a competitive market requires earnings constraints on LECs. It contends that infrastructure development

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343 CCTA Comments at 2; PaOCA Comments at 9; GSA Comments at 7; WilTel Comments at 25; Ad Hoc Comments at 24; see also CARE November 1994 Ex Parte Submission at 19 (recommending that the Commission retain the sharing mechanism because it provides insurance against excessive monopoly rates and constitutes the "[o]nly means to compensate ratepayers for LEC abuses of accounting and other rules").

344 CCTA Reply at 26-27.

345 PaOCA Comments at 10; GSA Comments at 7-8.

346 GSA Reply at 10.

347 AT&T Comments at 30, 35-37; MCI Comments at 32; ICA Comments at 14.

348 MCI Comments at 32.

349 ICA Comments at 14.

has proceeded apace under the current price cap regime and that earnings sharing is not inconsistent with a competitive market, because competing firms are in effect forced to "share" temporarily high earnings in order to survive in competitive markets.[350] Ad Hoc also argues that elimination of sharing under current conditions would be an unlawful abandonment of rate regulation, because it would violate Section 201 of the Communications Act by permitting LECs to set excessive rates, outside the range of reasonableness.[351]

179. MCI asserts that most LECs overstate fourth quarter expenses to manipulate their sharing obligations, and recommends requiring LECs to declare one-time accounting adjustments for the fourth quarter on or before September 15 of each year, and to file a justification and explanation of each adjustment, as well as its likely earnings impact.[352] In their replies, several LECs deny manipulating their earnings to undermine the sharing rules.[353] SWB says that company books and records are audited annually by independent external auditors and all booked expenses must meet GAAP accounting standards.[354] GTE argues that MCI's proposal that LECs declare all fourth quarter accounting adjustments by September assumes that all such adjustments would be known in advance and requires potential release of proprietary information.[355] NYNEX notes that the Commission has rejected arguments that it should look behind a LEC's reported earnings to decide whether a particular cost should be counted for purposes of applying the low-end or sharing adjustment mechanisms.[356]

180. In their comments filed in response to USTA's January 18 proposal, a number of LECs contend that the moving average allows the Commission to remove the sharing and low-end adjustment mechanisms, which they believe counteract the

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[350] Ad Hoc Reply at 10-13.

[351] Ad Hoc Reply at 19-21.

[352] MCI Comments at 32-34 & nn.55, 56.

[353] USTA Comments at 16-17; GTE Reply at 20; SWB Comments at 20-22; Pac Bell Reply at 14-16.

[354] SWB Reply at 21.

[355] GTE Reply at 22.

[356] NYNEX Reply at 67-68, citing 1992 Annual Access Tariff Filings, CC Docket No. 92-141, 7 FCC Rcd 4731, 4735 (Com. Car. Bur. 1992).

incentives of price cap regulation.[357] Pac Bell argues that sharing requires burdensome review of costs and earnings.[358] Pac Bell also alleges that IXCs rarely pass through the benefits of sharing to their ratepayers.[359] MCI and AT&T deny that the moving average justifies elimination of sharing.[360] GSA maintains that the sharing and low-end adjustment mechanisms are necessary regardless of level of X-Factor, to adjust for yearly fluctuations in earnings.[361]

b. Realigning the Backstop Mechanisms With Capital Costs

181. Many commenters urge the Commission not to realign the sharing and low-end adjustment mechanisms to reflect changes in capital costs.[362] Several parties contend that the Commission is legally precluded from prescribing a new LEC rate of return in this proceeding.[363] BellSouth and Sprint argue that it would be unreasonable for the Commission to initiate a proceeding to represcribe the cost of capital applicable to price cap LECs when it has retained 11.25 percent as the cost of capital applicable to AT&T price caps and cable television providers.[364] BellSouth and Pac Bell contend that changes in interest rates are already reflected in the GNP-PI component of the price cap adjustment formula.[365] Pac Bell says that adjustments to rate of return

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[357] Pac Bell January 18 Comments at 1-2; NYNEX January 18 Comments at 2 and Attachment; US West January 18 Comments at 2-3; SWB January 18 Comments at 6-7, 9-10.

[358] Pac Bell January 18 Comments at 2-3.

[359] Pac Bell January 18 Comments at 3.

[360] MCI January 18 Comments at 6-7; AT&T January 18 Comments at 7-8.

[361] GSA January 18 Comments at 4-5.

[362] NYNEX Comments at 32; BellSouth Comments at 47; Pac Bell Comments at 44; SWB Reply at 8; Sprint Reply at 20-22; USTA Reply at 7-8.

[363] USTA Reply at 12; BellSouth Comments at 48; Pac Bell Reply at 8-9; NYNEX Comments at 35 n.85.

[364] Sprint Comments at 20-24; BellSouth Comments at 47-48, _citing_ Implementation of Sections of the Cable Television Consumer Protection Act of 1992, MM Docket No. 93-215 and CS Docket No. 94-28, 9 FCC Rcd 4527, 4634-35 (1994).

[365] BellSouth Comments at 49; Pac Bell Comments at 45.

have no place in a price cap form of regulation where the goal is to control prices and not individual endogenous costs.[366] Sprint contends that there is no need to revisit the rate of return because the recent changes in cost of debt have been short-term.[367] Pac Bell states that current long-term interest rates have changed very little since the LEC rate of return was last represcribed.[368] Some LECs assert that the Commission has declined in the past to adjust the cost of capital solely based on fluctuations in interest rates.[369]

182. On the other hand, AT&T recommends that the benchmark rate of return used for setting the sharing and low-end adjustment triggers should be reset downward to reflect the decline in capital costs.[370] AT&T says that, between 1991 and 1993, the LECs' cost of capital averaged no higher than 9.93 percent. AT&T therefore recommends that, because the LECs' cost of capital during this period was 132 basis points lower than the current 11.25 percent rate-of-return threshold, the sharing and low-end thresholds should be reduced by 132 basis points.[371] MCI recommends that the sharing and low-end adjustment ranges should be adjusted downward to reflect the current cost of capital which, according to MCI, is 9.54 percent.[372] Specifically, MCI recommends that the low-end adjustment threshold be set at 8.54 percent, and the 50 and 100 percent sharing thresholds at 10.54 and 14.54 percent, respectively.[373] Based on findings of the California Public Utilities Commission regarding Pac Bell's intrastate price cap regulation, CCTA advocates basing the

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366 Pac Bell Reply at 8-9; USTA Reply at 7-8.

367 Sprint Reply at 21.

368 Pac Bell Comments at 44.

369 BellSouth Comments at 48, <u>citing</u> Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, 6 FCC Rcd 7193, 7201 (1991) (<u>Represcription Reconsideration Order</u>); NYNEX Comments at 33, <u>citing</u> <u>Represcription Order</u>, 5 FCC Rcd at 7527; <u>se also</u> NYNEX Comments at 33-34 (cost of capital based on both interest rate and cost of equity, and increased competition may increase costs of equity).

370 AT&T Comments at 3; GSA Comments at 7; OCCO Comments at 9; Ad Hoc Comments at 25; ARI Comments at 2-3.

371 AT&T Comments at 33-34.

372 MCI Comments at 30; <u>accord</u> CCTA Reply at 10-13.

373 MCI Comments at 30.

backstop mechanisms on a 10.00 percent rate of return.[374]

183. USTA, Pac Bell, and Sprint assert that the cost-of-capital calculations of AT&T and MCI are seriously flawed and do not support their recommendations for a sharing mechanism based on a lower rate of return.[375] These reply commenters assert that, contrary to claims of AT&T and MCI, the LECs' current cost of capital is between 11.64 percent and 11.82 percent.[376] USTA asserts that MCI improperly based its analysis on aggregated Regional Holding Company data rather than data based on individual Bell Operating Companies. According to USTA, results based on Regional Holding Company data reflect the impact of the capital structures of their unregulated businesses.[377] USTA claims that AT&T's historical analysis makes the same error as MCI's analysis, and that, in any case, the analysis is not relevant because it focuses only on data from 1991 to 1993.[378] Sprint argues that the LECs' prescribed rate of return tends to overstate their earnings, because the economic life of much LEC equipment is less than that reflected in depreciation rates prescribed by the Commission.[379]

3. Analysis

184. We tentatively hold that the sharing and low-end adjustment mechanisms should be eliminated as part of our new permanent price cap plan for LECs selecting a higher X-Factor. Consistent with our tentative finding that our plan should have at least two X-Factor options, we tentatively conclude that at least one option should be a pure price cap plan, with no sharing or low-end adjustment mechanism, and at least one of the lower options should feature sharing and a low-end adjustment mechanism. If we ultimately adopt a price cap plan that incorporates a moving average X-Factor, the ongoing routine updating of the X-Factor should provide reasonable rates to customers, including more complete flow-through of LEC efficiency gains, while enhancing the efficiency incentives of the plan and simplifying its administration. We will seek comments on these

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374 CCTA Reply at 10-11.

375 USTA Reply at 12; Sprint Reply at 25; Pac Bell Reply at 9-12.

376 USTA Reply at 12; Sprint Reply at 25; Pac Bell Reply at 9-12.

377 USTA Reply at 13-14 and Attachment 2 at 10-12.

378 USTA Reply at 14-15.

379 Sprint Reply at 24.

tentative conclusions in the further notice.

185. The purpose of the backstop mechanisms was to help ensure that LEC price cap rates remained reasonable in the event that the X-Factor was in error for the industry as a whole or, as a result of variations across the industry, for individual LECs. If the X-Factor was set too high or too low, the backstop sharing and low-end mechanisms would help to adjust the price cap indexes to correct the error. If the productivity growth of an individual LEC varied substantially from the industry average, the backstop helped keep its rates within a range of reasonableness.

186. In addition, the backstop sharing mechanisms served as an incentive for LECs to choose a higher X-Factor. The 1990 plan contained gradations in sharing, with somewhat more lenient sharing zones for the higher, optional 4.3 X-Factor. The plan thus sought to encourage LECs, through the prospect of retaining higher earnings, to accept the more challenging 4.3 X-Factor. This, in turn, would lead to rate reductions for consumers beyond those required by the lower 3.3 X-Factor. In this manner, the gradations in sharing for the two X-Factors "embod[ied] the concept of providing a profit incentive to LECs to further reduce rates."[380]

187. At the same time, we recognized that these mechanisms have drawbacks. By reducing the risks and rewards of LEC efforts and decisions, the backstop blunts the incentives for greater productivity that price caps seeks to create. These reduced incentives can be expected to generate lower LEC efficiency, which in turn would reduce the benefits of price caps to consumer welfare and the health of the national economy. The increased burdens of administering a price cap plan with the added complexities and regulatory burdens of a rate-of-return backstop represents a further loss to society. In addition, because these mechanisms are rate of return mechanisms, they create an incentive for cross-subsidization between regulated and nonregulated activities.

188. We remain convinced that a rate-of-return backstop reduces the efficiency incentives that can be generated by a pure price cap plan. The evidence in the current record lends further support to this conclusion. As noted above, the SPR study of the effects on incentives of the current sharing mechanism and four year review cycle finds that the current LEC price cap plan produces less than 35 percent of the efficiency incentives of unregulated competition, and that these incentives fall to only 18 percent for a LEC whose earnings are in the 50-50 sharing zone each year. As Ad Hoc points out, this study may overstate the

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380 LEC Price Cap Order, 5 FCC Rcd at 6801.

effect on possible incentives,[381] but even Ad Hoc's revised estimates indicate that the current backstop substantially reduces the efficiency incentives of the plan. Ad Hoc's estimates indicate that a pure price cap plan produces 86 percent of the efficiency incentives of unregulated competition, and that the sharing and the four-year review cycle reduce efficiency incentives to 69 percent of those experienced by competitive firms, and to 45 percent for firms in 50-50 sharing. Even by this more conservative calculation, ending sharing would thus generate at a minimum a 17 percent (86 percent minus 69 percent) increase in efficiency incentives for all LECs, and a 41 percent (86 percent minus 45 percent) increase for LECs in 50-50 sharing,[382] a category that currently includes most price cap LECs. These are substantial gains in incentives that the current plan suppresses. And, of course, eliminating the 100 percent sharing zone in the current plan would eliminate the possibility that a LEC that achieved high interstate earnings would have no incentives to increase efficiency.

189. A pure price cap plan, without earnings sharing, may also encourage infrastructure development and the deployment of advanced equipment and technology. Ameritech submitted a study that compares state regulatory experiences and concludes that incentive regulation generated faster deployment of modern equipment and technologies, but that earnings sharing dilutes the incentives to make infrastructure improvements.[383] This study, however, does not control for the effect of state-mandated investment requirements or agreements between state commissions and LECs that require the LECs to deploy advanced infrastructure,

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[381] Ad Hoc criticizes the SPR study for assuming that competitive firms retain all the benefits of efficiency gains in the form of higher profits indefinitely, even though such gains would be transitory as competing firms emulate such improvements. Ad Hoc also adjusts the SPR study's assumption that LECs will share 50 percent of high earnings, based on the fact that during the first few years of LEC price caps, the backstop mechanism's no-sharing zone reduced actual LEC sharing to only 20 percent of profits above the initial 11.25 percent rate-of-return target. Ad Hoc also assumes that a price cap LEC will face a periodic review every four years. SPR estimates that the possible threat to earnings of the periodic review reduces LEC incentives by 14 percent, compared to a competitive firm that would not face the risk of regulatory action that might reduce the profits of long term investments. Ad Hoc Reply at 16.

[382] See Ad Hoc Reply at 16.

[383] The Effect of Incentive Regulation on Local Exchange Companies' Deployment of Digital Infrastructure, Ameritech Reply at Attachment B (Ameritech/Greenstein-McMaster-Spiller Study).

even though these are common features of state price cap and social contract plans. Because it is not possible to replicate the study and control for this effect, the study's conclusions are open to question.

190. The backstop, even with its reductions in efficiency incentives, was reasonable during the initial price cap period, when we could not be certain that the X-Factors we had selected would be accurate for the price cap LECs in general or for individual LECs. Now, after four years of experience with LEC price caps, we are in a much better position to set reasonable X-Factors, using actual LEC performance data under price cap regulation. We no longer have to estimate their prospective performance under price caps. Thus, the need for a backstop to correct possible errors in the overall industry X-Factor is reduced, although not eliminated.

191. We believe that the record developed in this proceeding shows that the sharing mechanism deprives LECs and their customers of the full benefits of lower prices and improved efficiency that a pure price cap scheme can offer. We further believe that the performance of the LECs over the past four years of price cap regulation provides us with more reliable and accurate information with respect to the efficiency gains that LECs reasonably can be expected to achieve annually. Moreover, a price cap plan that provides for annual updates to the X-Factor on the basis of a moving average would ensure that the X-Factor reflects the actual performance of the LECs on a more timely basis. As a result, continuing gains in the average efficiency of the LECs' provision of regulated interstate access services would eventually be passed through to their customers.

192. If the methodology used to set the moving average is properly selected and applied, the X-Factor would be automatically adjusted each year for any increases or decreases in overall LEC performance, including changes in productivity, after whatever lag period is selected. Thus, the danger of an error in the X-Factor leading to unreasonably high or low rates is reduced substantially, if not eliminated.[384] A backstop to make these same corrections would be superfluous.

193. In sum, we believe that our long-term price cap plan should not require the continuation of sharing in order to ensure that the X-Factor represents an accurate measure of average annual LEC efficiency gains under price caps. We are mindful, however, that the sharing and low-end adjustment mechanisms were

[384] If we find at the conclusion of our further proceeding that error in the X-Factor cannot be eliminated, we will there set an appropriate mechanism to deal with the possibility of unreasonably high or low rates due to such error.

also intended to account for variations in the performances of individual LECs. We observed in the LEC Price Cap Order that "[i]ndividual LECs may experience significant variations from the industry productivity norm, not because of their own foresight and efforts but as a result of regional economic booms or recessions, among other factors."[385] The data obtained from the initial period of price cap regulation indicate that the efficiency gains that individual LECs have been able to sustain, as measured by their interstate earnings, have indeed varied significantly. In each year under price caps, the range of earnings of the LECs has spanned several hundred basis points. Some of the LECs have achieved efficiency gains that placed them in the sharing zones every year, while others have lagged significantly behind.[386] We note that USTA asks us to take these differences into account in any revised price cap plan by preserving the current lower X-Factor of 3.3 percent for LECs that are unable to maintain the industry-wide average rate of growth in efficiency.[387] We recognize that these differences among the price cap LECs may be attributable to differences in their responses to the incentives created by this scheme of regulation to improve their efficiency in providing their regulated services. We also recognize that in some cases these differences may be caused by factors over which the LECs have no control, such as the strength of the regional or local economies in the areas in which a LEC provides service. Since at this time we are unable to isolate the factors that contributed to a particular LEC's performance, the precise cause of the variations among companies is less important than the fact that the heterogeneity exists.

194. We tentatively concluded above that our long-term price cap plan should provide more than one X-Factor option in recognition of the differences in the LECs' performance. This structure, however, does not inherently create incentives for a LEC to select an X-Factor that most closely corresponds to its actual rate of efficiency gain. If we were to establish a price cap scheme with multiple X-Factor options, without some mechanism to require LECs deciding which option to select to weigh a trade-off associated with the lower options, it is patently obvious that every LEC, regardless of its actual productivity rate, would select the lowest option. That result clearly would not serve the public interest. USTA suggests that we can solve their "self-selection" problem by maintaining the current 3.3 percent

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[385] LEC Price Cap Order, 5 FCC Rcd at 6801.

[386] Appendix C, Table 5, lists the interstate earnings reported by the price cap LECs for 1991-1993 as well as their estimated earnings for 1994.

[387] See January 18 Letter.

X-Factor with the existing backstop mechanisms as an option only for smaller LECs that elected price cap regulation voluntarily. This could be fair and appropriate, USTA argues, because these carriers "are uncertain of their ability to achieve the scope and scale necessary to sustain productivity gains year after year in line with the industry average."[388] USTA, however, presents no specific evidence to support its assertion regarding the performance characteristics of the independent LECs that voluntarily elected price caps.

195. Because of the "self-selection" problem created by a price cap system that, in recognizing LEC heterogeneity, offers more than one X-Factor option, it is necessary to build into the system incentives for a LEC to opt for the X-Factor that most closely corresponds to the LEC's actual efficiency growth. That is to say, the price cap scheme should encourage a LEC with a lower rate of efficiency growth to select a lower X-Factor and encourage a more productive LEC to select a higher X-Factor.

196. One way to create these incentives is through the current sharing arrangements. Assume, for example, that a LEC's rate of productivity growth actually exceeds all of the X-Factor options offered under a price cap plan. Assume further that the price cap scheme allows the LEC to retain substantial earnings if it elects a lower X-Factor and greater earnings if it elects a higher factor. The sharing obligations associated with each of the factors would largely dictate the LEC's choice, since the LEC would have to decide whether the opportunity to retain a greater level of earnings at the higher option would offset the additional reduction in its PCI that the LEC would incur by selecting the higher option. Indeed, in an ex parte filing, Sprint proposed an approach with three X-Factors in which the sharing arrangement became more flexible as the X-Factor increased, with the highest X-Factor having no sharing.

197. We have discussed above the significant drawbacks of continuing to impose sharing in our price cap regulatory scheme. Accordingly, we tentatively conclude that the existing backstop mechanisms should eventually be eliminated and we should move to a system of pure price caps. Further, we would like to explore alternatives to the use of sharing to create the proper incentives for LECs to select an X-Factor that corresponds to their actual, internal X-Factor. We will seek comment on this issue in the next phase of this proceeding. In any event, if we eventually conclude some system of alternative X-Factors should be adopted, we believe that one of the options should be a pure price cap plan, with no backstop mechanisms.

D. Adjustments to the Current Plan

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388 January 18 Letter at 5.

198. We expect to complete this proceeding expeditiously and establish a long-term method for setting the X-Factors based on the LECs' actual performance under price caps. There remains the question whether interim adjustments to the current plan are necessary to ensure that rates remain just and reasonable, and that a reasonable balance between ratepayer and shareholder interests is achieved, during the time it will take to develop a new rate formula.

199. We are persuaded, based on the record before us, that our original X-Factors should be adjusted upward to correct for an error in our original estimate of the historical X-Factor for the period 1984-90. A simple upward adjustment would produce corrected X-Factors of 4.0 and 5.0. We also find, however, that, in light of the demonstrated heterogeneity of the LEC industry, the range of evidence in the record concerning LEC performance under price caps, and our present inability, absent further specific information, to reach definitive decisions based upon that evidence, a wider range of X-Factors is warranted to achieve an appropriate balance of interests for each LEC during this interim period. We therefore establish for this period a minimum X-Factor of 4.0 percent and two optional X-Factors of 4.7 and 5.3.

200. LECs selecting the highest X-Factor will not be subject to sharing, nor will they be permitted to make low-end adjustments. LECs choosing an X-Factor of 4.7 will be allowed to keep all earnings up to 12.25 percent, will be required to share half of their earnings from 12.25 percent to 16.25 percent, and will be required to share all of their earnings above 16.25 percent. LECs selecting the lowest X-Factor option will keep earnings up to 12.25 percent, share half of earnings from 12.25 percent to 13.25 percent, and share all earnings above 13.25 percent. These sharing zones are designed to encourage each LEC to elect the X-Factor that is closest to the X-Factor it is likely to achieve, and to discourage LECs with higher productivity from selecting the lower X-Factors. We retain the current low-end adjustment mechanism for those choosing the two lower X-Factors.

1. Correction of the Original X-Factor Analysis

201. In the LEC Price Cap Order the Commission selected a baseline productivity factor of 2.8 percent, based on the results of two studies conducted by the Commission staff. The Frentrup-Uretsky short-term study examined LEC switched access rates in the tariff years 1984-1990 and produced a productivity factor of 3.5 percent. The Spavins-Lande long-term study derived a productivity factor of 2.1 percent from telephone industry price data during the period 1928-1989. The Commission developed a factor of 2.8 percent, based on the average of the results of

these two studies, characterizing this choice as a "conservative minimum figure."[389] A 0.5 percent CPD was added, so that the total productivity offset became 3.3 percent.

202. Although the Commission concluded at the time that it had been conservative in its selection of a baseline productivity figure, it also viewed the price cap plan as a whole, including the CPD and the 50-50 common line formula, as presenting a significant productivity challenge to LECs seeking higher earnings.[390] Evidence now on the record, however, indicates that the productivity hurdle was not as challenging as the Commission anticipated.

203. LEC earnings have risen rapidly during the initial price caps period, to the point where, in 1993, all seven BOCs, Contel, Lincoln, and a number of Sprint operating companies were in the 50-50 sharing zone.[391] Earnings for 1994 also appear high, with preliminary reports showing five BOCs, Lincoln, and most Sprint companies in the 50-50 zone, and several Sprint companies at or near the 100 percent sharing mark.[392] We agree with MCI and others who argue that the earnings achieved by LECs under price caps suggest that the productivity offset may have been too low, resulting in a price cap plan that was not as challenging as the Commission intended it to be. In our original conception, sharing was not intended or foreseen to be a routine occurrence. Rather, we consistently described sharing as a backstop mechanism, in the event that unanticipated errors in the price cap formula, or circumstances peculiar to a particular company, rendered the formula inaccurate for a company at a given time.[393] Indeed, we did not believe that any carrier would reach the 100 percent sharing level during the first four years of price caps, and that such a rise would more likely indicate an error in the factor or an unusual variation from the industry norm than newly-achieved productivity.[394] The fact that sharing has become routine for most price cap LECs indicates to us that we should reexamine our original productivity factor to determine if we made an error in its specification. Moreover, even assuming arguendo that the LECs are correct that interstate

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389 LEC Price Cap Order, 5 FCC Rcd at 6798.

390 Id. at 6799, 6801.

391 Letter from Mary McDermott, USTA, to Acting Secretary, March 14, 1995 (USTA March 14 Letter).

392 Id.

393 LEC Price Cap Order, 5 FCC Rcd at 6801.

394 Id. at 6804.

earnings, based on regulatory accounting and separations rules, do not reflect economic costs, it is significant that LEC earnings have increased each year under price caps.

204. New evidence submitted in this docket confirms the need to reassess our previous determinations with respect to historical LEC productivity. The USTA TFP study provides new productivity data for the 1984-1990 period covered by the Frentrup-Uretsky Study. As explained in Appendix F to this order, the results of the USTA Study must be adjusted to account for input price differentials during the period covered by the study.[395] When so adjusted, the USTA Study indicates that LEC productivity growth rates for the years 1984-1990 were significantly higher than the Frentrup-Uretsky results for the same period. Accordingly, we have re-examined the Frentrup-Uretsky Study to see what might account for this difference.

205. As MCI notes in its comments, there was considerable controversy concerning our decision to include in the Frentrup-Uretsky Study the access price data from the 1984-85 tariff year (the "1984 data point").[396] This data point was, perhaps, the single most contentious aspect of our productivity analysis. Statistical analyses showed this data point to be an outlier.[397] Even after several adjustments, the data point did not fit the trend described by the 1985-90 data.[398] Nevertheless, the Commission ultimately decided out of an abundance of caution that the disputed data point provided relevant information and should be included in order to give the most complete possible picture of post-divestiture productivity.[399] Although the Commission exercised its best judgment in reaching this decision, the decision was not compelled by the evidence. Indeed, it appears that the record would have afforded the Commission discretion to have excluded the data point as well. The inclusion of the 1984 data point, therefore, appears to be a likely source of error in the Frentrup-Uretsky results. For the reasons set forth below, based on the record developed in this proceeding, that exclusion of the 1984 data point will provide a more reliable measure of LEC productivity in the immediate post-divestiture period.

206. The Common Carrier Bureau staff has performed an

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395 See Appendix F, infra.

396 See LEC Price Cap Order, 5 FCC Rcd at 6797 and Appendix C at 6892-94.

397 LEC Price Cap Order, Appendix C, 5 FCC Rcd at 6892-94.

398 LEC Price Cap Order, Appendix C, 5 FCC Rcd at 6892-94.

399 LEC Price Cap Order, 5 FCC Rcd at 6797.

analysis to determine what X-Factor the Frentrup-Uretsky Study would have produced had the 1984 data point been excluded. This study is reported in Appendix D of this Order. The revised Frentrup-Uretsky Study shows that, without the 1984 data point, the short-term historical X-Factor would have been 5.0 percent.

207. As noted above, the USTA TFP Study, adjusted for input price differential, produced a productivity figure around 4.8 percent for the period 1985-1990. The USTA data thus corroborate, in a general way, the range produced by the revised Frentrup-Uretsky Study, supporting the argument that the 1984 data point should have been excluded from the original study. We also observe that, unlike the Frentrup-Uretsky Study, the USTA Study does not show disparate results for the periods 1984-90 and 1985-90. If LEC productivity gain in the 1984-85 tariff year were really as different from the subsequent five years as the 1984 data point would indicate, that difference should have shown up in USTA's TFP Study. The fact that the USTA TFP Study results are not much affected by the inclusion or exclusion of 1984-85 data lends additional credence to the view that the data underlying the 1984 data point in the Frentrup-Uretsky Study was seriously flawed.

208. We now conclude that we erred in 1990 and that the 1984 data point should have been excluded from the Frentrup-Uretsky Study. We base this conclusion on (1) the statistical critique presented in the LEC Price Cap proceeding, which demonstrated that the data point was an outlier; (2) the new evidence of the adjusted USTA TFP Study showing LEC productivity during the period 1984-90 to have been much higher than was shown by the Frentrup-Uretsky Study; (3) the fact that elimination of the 1984 data point from the Frentrup-Uretsky Study brings the study into line with the USTA TFP results (once corrected for input price differential); and (4) the evidence from the USTA TFP Study indicating that productivity for the year 1984-85 was not, in fact, anomalous if correctly measured. Our conclusion is supported by the observation of a rapid rise in LEC earnings under price caps, which suggests that the productivity factor used during the initial price caps period was too low.

209. In the LEC Price Cap Order, we averaged the 3.5 percent factor from the short-term Frentrup-Uretsky Study with the 2.1 percent factor from the long-term Spavins-Lande Study to compute an average of 2.8 percent. The 0.5 percent CPD was then added to set the minimum X-Factor of 3.3 percent. Based on the additional information in the current record, and for the reasons described above we conclude that the short-term study should be corrected to exclude the controversial 1984 data point. This results in a corrected short-term study factor of 5.0 percent. Consistent with our methodology for computing the X-Factor in 1990, when this is averaged with the result of the long-term study, the new average is 3.5 percent. Adding the 0.5 percent

CPD would produce a minimum X-Factor of 4.0 percent. Thus, correcting our prior error in 1990 and, employing the same averaging methodology, leads to a calculation that 4.0 percent is a more accurate measure of LEC productivity and a more appropriate minimum X-Factor for our revised price cap plan.

2. Selection of New X-Factors

210. In the LEC Price Cap Order we selected an X-Factor of 3.3 percent in the manner described above, then added 1 percent to create a higher, optional X-Factor of 4.3 percent. Carriers selecting the higher X-Factor were allowed a wider, 200 basis point no-sharing zone, but were still subject to sharing obligations. If we were simply to make the mathematical adjustment to our existing plan, we would now set a minimum X-Factor at 4.0 and a higher, optional X-Factor at 5.0.

211. The record before us, however, provides several reasons why we should not simply mathematically adjust the existing plan, but rather should make other adjustments as well. First, as discussed in the previous section of this Order, we have found that, assuming an appropriate X-Factor could be chosen, a price cap plan without sharing would be better than a plan with sharing. We find, therefore, that our interim plan should include an X-Factor option without sharing. This approach represents a cautious, but still significant, step toward our tentative conclusion that sharing should be eliminated at the earliest feasible opportunity.

212. Second, few LECs chose the 4.3 percent X-Factor, although a number of companies experienced high earnings several years in a row and were repeatedly required to return a portion of those earnings to ratepayers through sharing. This experience suggests that the LECs perceived the risk involved in accepting a permanent one percent reduction in the PCI to have been too large in comparison to the reward that was offered, i.e., the opportunity to earn for one year an interstate rate of return of up to 13.25 percent without sharing and up to 15.25 percent, net of sharing. We believe that carriers may be more likely to choose X-Factors above the minimum level if the interval between options is somewhat smaller than one percent, and the difference in sharing zones between options is greater.[400] These two changes, acting in tandem, can lead to a wider gap in the effective rate of return permitted under the various options. The opportunity to earn a higher rate of return would create a greater economic incentive for LECs to aspire to the higher X-Factors available under the new plan. By creating profit incentives for LECs to opt for the higher X-Factors, we seek to further two goals -- greater rate reductions for consumers of

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[400] See Section IV.D.3, infra.

those LECs that move up from the minimum 4.0 X-Factor; and moving carriers toward a "pure" price cap option with no sharing, consistent with our long-term goals on this issue.

213. Third, as discussed in the preceding section of the order, the price cap LECs now appear to display significantly greater heterogeneity than under rate of return regulation. Some have required low-end adjustments, while others have been in the sharing zone every year. The wide range of earnings results indicates that some LECs may be sufficiently challenged by an increase in the minimum X-Factor from 3.3 to 4.0, some might experience high earnings at 5.0, and others may fall somewhere in between. In light of this diversity, we conclude that our interim plan should offer three X-Factor options, structured so that each LEC is likely to choose the option that is closest to its own implicit X-Factor. In this way a better balance of ratepayer and shareholder interests will be achieved for each LEC and its customers.

214. Accordingly, instead of setting one optional X-Factor at 5.0, we will establish two optional X-Factors at equal intervals above and below that level. The optional X-Factors will thus be 4.7 and 5.3, with a minimum X-Factor of 4.0. We believe these optional X-Factors, with narrower gaps between the options and coupled with the sharing zones discussed below, will encourage LECs to become more productive and efficient, so that customers benefit from lower prices and innovative services. We recognize that there are alternative optional X-Factors that we could have selected for this interim period. The ratemaking process, however, is "not an exact science."[401] Rather, it involves making predictive judgments about the future, and requires us to exercise our expertise and informed judgment in balancing the interests of consumers and shareholders. We believe the plan we adopt here strikes an appropriate balance among the relevant public interest factors, particularly given the interim nature of the plan.

215. Thus, to summarize, the benefits of moving from two to three options are, first, that three options offer LECs a greater number of choices, and thus better reflect the heterogeneity of past performance and choices among LECs. Second, three options provide carriers greater flexibility. Third, the middle option provides LECs an additional opportunity to move away from the minimum X-Factor to a higher step, offering greater earnings opportunities in return for a larger up-front reduction in a LEC's PCIs and leading to reduced rates for consumers. Finally, the revised plan encourages continued movement away from rate-of-return regulation, as the highest option eliminates the sharing

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[401] United States v. FCC, 707 F.2d 610, 618 (D.C. Cir. 1983).

obligation and provides incentives for higher productivity levels.

216. We reject MCI's proposal that we rely solely on the corrected short-term study to set a minimum X-Factor. As we recognized in setting the initial minimum X-Factor, the short-term and long-term studies each have strengths and limitations.[402] The short-term study's strengths include its focus on data on the post-divestiture performance of the LECs under rate of return regulation, including performance under this Commission's switched access rules. Its weaknesses, however, are significant. The study includes only a few data points and those points reflect a period of expansion, without a recession or downturn, and so represent only one part of a business cycle. The study does not include special access, and requires numerous complex adjustments[403] for events since divestiture, each of which has the potential to introduce errors in the result. As we have seen, this result is also highly sensitive to data from a single year. The long-term study has, comparatively, the important strength of perspective, based on a longer series of data from a range of economic conditions and technologies. The long-term study's result is also consistent with other telephone productivity studies submitted in the original record.[404] Its weaknesses include its lack of adjustment for cost changes since divestiture or for changes in profits over time, as well as its heavy weighting toward pre-divestiture Bell System data. We remain convinced that both studies provide useful information on historical LEC productivity, and that we should continue to make use of both studies in establishing interim X-Factors, pending the completion of the further rulemaking to set a permanent X-Factor methodology.

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[402] LEC Price Cap Order, 5 FCC Rcd at 6798.

[403] Such adjustments include: (1) the transition of the subscriber plant factor to 25 percent; (2) the revised separations treatment of local commercial operations expense; (3) the direct assignment of closed-end WATS access lines to the special access category; (4) the implementation of reserve deficiency amortizations to compensate for inadequate depreciation levels; (5) the effects of the 1986 Tax Reform Act; (6) the revised separations calculation of the dial equipment minutes (DEM) factor; (7) the revised separations treatment of central office equipment category 4 terminations; (8) the revised separations treatment of revenue accounting expenses; (9) the adoption of the new Part 32 Uniform System of Accounts, including conformance of Parts 36 and 69 of the Rules to Part 32; and (10) the revised treatment of pension expenses. See LEC Price Cap Order, Appendix C, 5 FCC Rcd at 6887.

[404] Id., 5 FCC Rcd at 6798.

217. None of the other commenters discussing LEC productivity has submitted independent evidence sufficient to enable us to adopt their recommendations at this time. Many parties base their arguments on AT&T's studies, or studies submitted by other parties. As explained above, we need to seek further comment before we can determine whether to adopt an X-Factor methodology based USTA's TFP methodology, AT&T's proposal, or some other methodology. In any case, no other parties submitted detailed studies or analyses comparable to those submitted by USTA or AT&T that would support adoption of their recommendations. Furthermore, we find that the 5.29 percent productivity factor developed by the panel of Pennsylvania PUC administrative law judges cited by ARI and PaOCA, although relevant in an examination of Pennsylvania intrastate rates, cannot by itself support a productivity factor for nationwide interstate access rates. In sum, we will not consider further these other X-Factor recommendations at this time.

3. Sharing Zones

218. The primary function of sharing during the first four years of price caps has been as a backstop to the price cap plan. As noted above, however, varying the sharing zones for the original two X-Factor options provided profit incentives for LECs to consider opting for the higher 4.3 percent X-Factor.[405] Most LECs in most years selected the 3.3 X-Factor, which represented our best estimate of the average productivity offset for the industry, and the sharing mechanism kept the rates charged by the most efficient companies within the prescribed zone.

219. As discussed in Section C, above, sharing zones can serve another purpose in a plan with multiple X-Factor options. Sharing requirements can be established so as to dissuade carriers from selecting options lower than their own actual X-Factors. Although we would prefer in the long-term to find some other method of encouraging each LEC towards the highest X-Factor, and thus the lowest rates, it can sustain, the record to date in this proceeding is insufficient to enable us to determine whether any substitute would have the same efficacy. We will, therefore, set the sharing zones in our interim plan so as to provide incentives for carriers to select appropriate X-Factors. As noted above, we seek to structure sharing zones to provide for greater rate reductions and to move carriers toward a pure price cap option.

220. LECs selecting the highest X-Factor, 5.3, will not be subject to sharing. This X-Factor is two percentage points above the current X-Factor that most LECs have selected and 1.3 percentage points above the minimum X-Factor in our interim plan.

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[405] See LEC Price Cap Order, 5 FCC Rcd at 6801.

Hence, we believe that this X-Factor represents a major challenge over the short period of time that this interim plan will be in effect. Nonetheless, we believe that the opportunity to retain all profits earned may attract the most efficient LECs to this option.

221. LECs choosing the 4.7 X-Factor will be subject to the same sharing requirements that attach to the minimum X-Factor in the original plan: they must share with ratepayers half of their earnings from 12.25 percent to 16.25 percent, and must return to ratepayers all earnings above 16.25 percent. While this X-Factor will be challenging, the performance of the industry to date under price caps indicates that the LECs have responded to the incentives created by this system by increasing their annual rate of efficiency gains. Thus we believe that many LECs can achieve the productivity growth implied by this X-Factor.[406] Moreover, carriers electing this option will have an opportunity to earn a return of up to 14.25 percent on their interstate investment base. In our view, these sharing bands create a reasonable incentive for certain LECs to elect this option, but the potential sharing obligations should discourage more efficient LECs from choosing this option if they can offset the higher 5.3 percent X-Factor by increasing the efficiency of their operations.

222. Those LECs that choose the lowest X-Factor will be subject to a significantly more restrictive sharing obligation. They will be required to share half of their earnings from 12.25 percent to 13.25 percent, and will be required to return all earnings above 13.25 percent. These sharing zones are intended to serve two purposes. For LECs that have lagged behind other LECs in their performance under price caps, for whatever reason, this minimum X-Factor establishes a conservative offset, since it is based on LEC performance data from cost-of-service years. Presumably, LECs facing such circumstances are not likely to earn high returns, and thus should incur few, if any, sharing obligations, despite the more stringent sharing zone. Further, for LECs that are able to achieve higher productivity gains, the narrow sharing zones should discourage such LECs from electing this option. Rather, the opportunity to retain a greater share of their earnings should encourage these LECs to select one of the higher options.

223. We have decided to retain for this interim period the low-end adjustment mechanism for LECs electing the 4.0 or 4.7 percent X-Factor. The other protections against confiscatory

[406] Indeed, while we have previously stated that the Frentrup-Uretsky short-term study should not be the sole basis for determining the X-Factor, we believe it generally shows that this X-Factor is within the reach of some LECs.

rates cited by MCI, an above-cap tariff filing and a petition for waiver of the price cap rules,[407] are, potentially, burdensome to the Commission, LECs, and customers alike. Our cost support standards for above-cap filings are extensive and rigorous,[408] and we anticipate that any above-cap tariff filing would be suspended for the full five-month statutory period and subject to a lengthy investigation.[409] We continue to find it both fair and prudent, for this interim period, to provide for a measure of automatic relief for LECs experiencing low earnings. In this way we hope to avoid both confiscatory rates and extended rate proceedings. Furthermore, it may not be reasonable to require sharing when LECs experience high earnings without allowing a low-end adjustment when those LECs experience low earnings.[410]

224. We adopt the three interim X-Factors and their associated sharing and adjustment rules pursuant to our general rulemaking authority under Sections 4(i) and 201-203 of the Act and under our prescription authority contained in Section 205 of the Act.[411] Consistent with our approach in 1990, we will not entertain complaints filed pursuant to Section 208 of the Act, claiming that overall company earnings that are consistent with this prescription are excessive. Complaints that particular rates are unjust and unreasonable in light of the relevant costs and profits, or that they are discriminatory, may continue to be filed.[412]

225. Some commenters have raised substantive and procedural issues regarding our authority to end sharing or change the rate of return levels that trigger sharing obligations in the backstop. Ad Hoc contends that the elimination of sharing would be unlawful, because it would ignore the requirement of Section 201 of the Communications Act that rates be just and reasonable and cannot be reconciled with the Commission's earlier reasoning on the need for earnings sharing.[413] We find no basis for this argument. Section 201(b) of the Communications Act does require just and reasonable rates, but neither that section nor other section of the Act require any specific method be used to achieve

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[407] MCI Comments at 32.

[408] <u>LEC Price Cap Order</u>, 5 FCC Rcd at 6823-24.

[409] <u>Id</u>.

[410] <u>Cf.</u> <u>AT&T v. FCC</u>, 836 F.2d 1386 (D.C. Cir. 1988).

[411] <u>See</u> <u>LEC Price Cap Order</u>, 5 FCC Rcd at 6836.

[412] <u>See</u> <u>id</u>.; <u>see also</u> <u>AT&T Price Cap Order</u> at 3100, 3135-36.

[413] Ad Hoc Reply at 19-21.

that goal. While we have the authority and discretion to set rates of return as a method of assuring reasonable rates,[414] rate-of-return regulation is not a statutory requirement. Various methods may be used to set rates, provided the total effect is just and reasonable.[415] This Commission has, for example, adopted a pure price cap plan for AT&T as well as incentive regulation plans for LECs that do not contain rate-of-return backstop mechanisms.[416] We also find no inconsistency with the goals of price caps or our earlier statements. We have always recognized the drawbacks of the backstop, particularly its dampening effect on productivity incentives; we included the backstop as a "cautious and careful approach" to price caps that we stated we would consider ending in this performance review.[417] Ending the backstop only for LECs willing to elect a substantially higher X-Factor represents a continued careful step toward improving the LEC price cap plan, strengthening the productivity incentives of the plan while assuring reasonable rates during the interim period it is expected to be in place.

226. Some LECs, though supporting ending the backstop, nonetheless contend that the Commission may not adjust the rate of return levels in the backstop in this proceeding. NYNEX contends that the language of the Notice seeking comment on "[w]hether the sharing and low-end adjustment mechanisms should be realigned with capital costs, and if so, how this should be done" does not provide adequate notice needed to resolve the specific issues involved in effecting a realignment.[418] To the contrary, however, the question of "how" a task should be done is understood in normal usage to include consideration of the specific details necessary to complete the task, not just the way it would be started. The general discussion of the backstop issues also made clear to the reader of the Notice that the rate of return levels in the backstop were subject to revision in this

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[414] Nader v. FCC, 520 F.2d 182 (D.C. Cir 1975).

[415] Federal Power Commission v. Hope Natural Gas, 320 U.S. 591 (1944); Permian Basin Area Rate Cases, 390 U.S. 747 (1968); Farmers Union Central Exchange v. FERC, 734 F.2d 1486 (D.C. Cir.), cert denied, 469 U.S. 1034 (1984).

[416] Sections 61.39 and 61.50 of the Commission's Rules, 47 C.F.R. §§ 61.39, 61.50; and Section 61.41 et seq. of the Commission's Rules, 47 C.F.R. § 61.41 et seq.

[417] LEC Price Cap Order, 5 FCC Rcd at 6801, 6805.

[418] NYNEX Reply at 46-47.